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IN THE

Supreme Court of the United States

OCTOBER TERM, [redacted] 1969

No. [redacted] 220

JEFFERSON STANDARD LIFE INSURANCE COMPANY,
Petitioner

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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IN THE

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OCTOBER TERM, 1968

No.

JEFFERSON STANDARD LIFE INSURANCE COMPANY,
Petitioner

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Fourth Circuit entered in the cases between the above parties on March 13, 1969 (App. 36a-39a).

OPINIONS BELOW

The opinion of the Court of Appeals for the Fourth Circuit is reported at 408 F. 2d 842 (1969) (App.

1a-35a). No opinion was entered by the District Court. The Findings of Fact and Conclusions of Law of the District Court are reported at 272 F. Supp. 97 (1967) (App. 40a-93a).

JURISDICTION

The judgment of the Court of Appeals for the Fourth Circuit was entered on March 13, 1969 (App. 36a-39a). The jurisdiction of this Court is invoked under Section 1254(1), Title 28, United States Code.

QUESTIONS PRESENTED

(1) Whether the increase in loading on deferred and uncollected premiums constitutes income to be included in computing gain from operations of a life insurance company;

(2) Whether loading on deferred and uncollected premiums constitutes an "asset" within the meaning of Section 805(b)(4) of the Internal Revenue Code;[1]

(3) Whether interest prepaid or charged in advance is includible in income prior to the taxable year in which it is earned;

(4) Whether portions of charitable contributions of life insurance companies are deductible from gross investment income in Phase I as general expenses allocated in part to investment expenses;

(5) Whether the reserves established by the taxpayer as insurer for its Branch Office Managers' Supplemental Retirement Plan are "life insurance reserves" as defined in Section 801(b);

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[1] Hereafter section numbers not otherwise identified are references to sections in the Internal Revenue Code of 1954 applicable to the years involved.

(6) Whether agents' debit balances are used in an insurance trade or business so as to be excluded from "assets" as defined in Section 805(b)(4);

(7) Whether, on consolidated returns of life insurance companies, dividends distributed within the affiliated group should be eliminated in computing investment yield, and whether investment in another member of the group should be eliminated from assets for Phase I purposes;

(8) Whether the 2% additional tax imposed by Section 1503(a) on certain consolidated returns applied to consolidated returns of life insurance companies; and

(9) Whether Section 818(a) provides that, in the absence of contrary statutory provisions, computations prescribed by the National Association of Insurance Commissioners for annual statement purposes should be used in computing taxable income of life insurance companies.

STATUTES AND REGULATIONS INVOLVED

The following statutory provisions are involved, and the pertinent parts are set forth in App. 94a-112a: Sections 11, 170, 446, 451, 801, 802, 804, 805, 809, 818, 1501, 1502, and 1503 of the Internal Revenue Code of 1954.

The following Treasury Regulations are involved, and the pertinent parts are set forth in App. 112a-126a: Regs. Sections 1.446-1, 1.451-1, 1.801-4, 1.801-5, 1.805-5, 1.809-4, 1.818-2, 1.1502-1A, 1.1502-11A, 1.1502-30A, and 1.1502-31A.

STATEMENT

Jefferson Standard Life Insurance Company (Jefferson) and Pilot Life Insurance Company (Pilot) are domestic stock life insurance companies taxable under Part I of Subchapter L of Chapter 1 of the Internal Revenue Code (Section 801 et seq.). (App. 41a) During 1958 and 1959 Jefferson owned all the stock of Pilot, and the two companies filed a consolidated income tax return for each year, Jefferson acting as agent for Pilot for consolidated return purposes. (App. 41a-42a)

Jefferson filed suit for recovery of certain income taxes paid for each of the years 1958 and 1959, and the Government filed a counterclaim for each such year asserting liability for additional income taxes. (App. 43a) The cases were tried in the Middle District of North Carolina without a jury. (App. 40a) Both parties appealed to the Court of Appeals for the Fourth Circuit. This petition is for review of specified portions of the judgments of the Court of Appeals.

The years involved were the first years subject to taxation under the Life Insurance Company Income Tax Act of 1959, which completely revised the method of taxation of life insurance companies and, for the first time since 1921, subjected them to tax on the basis of an annual determination of income from all sources.

The material facts are not contested, and the Court of Appeals did not change any of the findings of fact made by the District Court.

A summary of the facts with respect to each of the issues is as follows:

1 and 2. *Treatment of loading on deferred and uncollected premiums.* The gross annual premium is the amount paid each policy year by an insured to a company for coverage. It is composed of two elements:

(1) The net valuation premium, which is the annual amount needed to pay policy claims over the years according to the mortality tables and assumed rates of interest used in writing the policy. This is the amount placed in the life insurance reserves to cover the company's liability under the policy. (App. 71a)

(2) The "loading", which is the difference between the net valuation premium and the gross premium. (App. 71a)

Life insurance companies are required to report on the basis of a calendar year for purposes of both their income tax returns and their annual statements prescribed by the National Association of Insurance Commissioners (N.A.I.C.). It is common practice in the life insurance industry for some policyholders to pay premiums in semi-annual, quarterly, or monthly installments. "Deferred premiums" are fractional premiums on policies with premiums payable in monthly, quarterly, or semi-annual installments which fall due after December 31 of the calendar year and before the end of the current policy year. "Uncollected premiums" are annual or installment premiums which, at December 31 of a calendar year, have become due but have not yet been paid.[2] (App. 70a)

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[2] This issue also involves the increase in loading on "due and unpaid" premiums, which are premiums on accident and health policies written by Pilot which have become due and have not been collected by December 31. Such premiums are in the nature of "uncollected" premiums, and are treated here as coming within the general category of deferred and uncollected premiums. (App. 75a-76a)

Both deferred premiums and uncollected premiums are premiums that have not been received by the plaintiff. Further, the company has no contractual or other legal right to enforce their collection. (App. 73a)

State law requires that there be added to reserves each year the amount of the net valuation premiums, including the net valuation portion of the gross premiums that are deferred and uncollected. (App. 71a) Since the company has not received deferred and uncollected premiums and has no legal claim to them they would not normally be accrued for income tax purposes. Notwithstanding this, it is necessary, in order for the accounts to balance, to accrue as income the net valuation portion of deferred and uncollected premiums. Consistent with state law requiring maintenance of reserves, the net effect of the N.A.I.C. annual statement form requires the inclusion in income and in assets of the net valuation portion of deferred and uncollected premiums. This is accomplished by a two-step procedure: (1) the accrual in income of gross deferred and uncollected premiums based on an assumption (for accounting convenience) that the full annual premiums have been paid in advance; and (2) an adjustment by which an offsetting entry is made to eliminate the loading on such premiums. It is not necessary to go through this two-step procedure in order to increase assets by the amount of the net valuation premiums. An identical result would be reached if only the net valuation portion of deferred and uncollected premiums were accrued as income. The loading on deferred and uncollected premiums does not enter into the computation of reserves, which are based only on net valuation premiums. (App. 71a and 75a)

The same computations and the same figures were used with respect to loading on deferred and uncollected premiums for purposes of the 1958 and 1959 income tax returns as were used for the annual statements approved by the N.A.I.C. that were filed by the companies. (App. 73a)

The taxpayer contended that the increase[3] in loading on deferred and uncollected premiums should be excluded from income in computing gain from operations, and that the amount of loading on deferred and uncollected premiums should be excluded from assets.[4] The District Court held against the taxpayer on these questions, (App. 91a-92a) and the Court of Appeals affirmed. (App. 23a-27a)

3. *Unearned Interest Income.* In 1957, 1958, and 1959, Jefferson and Pilot received prepayments of interest on loans to policyholders, and on bonds, mortgage loans, and collateral notes. Also, Jefferson charged loan accounts of policyholders who did not prepay interest on their loans on the policy anniversary date with a year's interest in advance. When a loan to a policyholder was made initially, the face amount of the note included the amount lent plus interest on that amount for one year. (App. 65a-67a)

Where interest had been prepaid and then the principal of the debt was paid, the company was obligated to refund any unearned interest. Similarly, where un-

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[3] The increase in loading is determined by subtracting the loading on deferred and uncollected premiums at the end of the prior year from the loading on such premiums at the end of the current year.

[4] Under the Phase I computation an overstatement of assets results in an increase in the company's taxable investment income.

earned interest had been added to a policyholder's loan account, Jefferson credited the policyholder with any unearned interest when the loan was paid. Where a policy loan was paid before the end of the first year (for which interest had been included in the face amount of the note), the unearned interest was paid to the policyholder or his beneficiary. (App. 67a)

For their own books, their N.A.I.C. annual statements, and the tax returns, Jefferson and Pilot, at the close of each calendar year, treated the unearned portion of interest paid in advance and the unearned portion of unpaid interest added to policy loan accounts in advance (or included in the face amount of the loans for the first year) as deferred items to be taken into income in the following year or years as earned. (App. 67a-68a) Under this method of accounting, the interest income for a calendar year was precisely equal to the interest earned during that year for the use of borrowed funds during that year. Interest income was required to be computed and reported in this manner on the N.A.I.C. annual statements. (App. 68a)

The District Court held that the full amount of interest must be reported as income in the year in which it was charged in advance, whether or not actually received, (App. 90a) and the Court of Appeals affirmed. (App. 27a-29a)

4. *Charitable Contribution Expense.* Jefferson and Pilot made charitable contributions in 1958 and 1959. The contributions were made principally to organizations in North Carolina and particularly in the Greensboro-High Point area where their home offices were located. In each year, each company allocated a portion of its charitable contributions to investment expenses and a portion to underwriting expenses. Jef-

ferson based its allocation on the ratio of employees engaged in investment functions to total employees, and Pilot based its allocation on the ratio of salaries of employees engaged in investment functions to total salaries. (App. 68a-69a)

Life insurance companies are required to allocate charitable contributions between investment expense and underwriting expense on a reasonable basis for their N.A.I.C. annual statements. The methods of allocation used by Jefferson and Pilot were consistent with that requirement and have been accepted for many years by the state insurance departments for purposes of the annual statements. (App. 69a-70a) The charitable contributions did not exceed the 5% limitations in Section 170(b)(2) or in Section 809(e)(3)(A). (App. 69a)

On the 1958 and 1959 tax returns, the portions of charitable contributions that had been allocated to investment expense were deducted as such pursuant to Section 804(c)(1) in computing taxable investment income for Phase I. The issue is whether this treatment was correct or whether the entire amount of the charitable contributions were deductible under Section 809(d) in computing gain from operations for Phase II. The District Court upheld taxpayer's treatment, (App. 91a) but the Court of Appeals reversed, holding that no part of the charitable contributions deductions should be taken into account in computing taxable investment income for Phase I. (App. 10a-14a)

5. *Treatment of reserves for Branch Office Managers Retirement Plan.* During 1958 and 1959 Jefferson had in effect a pension plan for its branch office managers.

(App. 57a and 62a) The reserves for the plan were computed on recognized mortality tables and assumed rates of interest and were included in Jefferson's regular reserve funds. (App. 61a) The reserves were set aside to mature or liquidate future annuity claims (App. 61a); they arose under annuity contracts which involved life contingencies at the time the reserves were computed (App. 61a-62a); the reserves were required by the law of North Carolina (App. 61a and 110a-112a); they were treated on Jefferson's annual statements in the same manner as reserves for annuity contracts written by Jefferson and issued to the public generally (App. 62a-63a); and the reserves for the Plan were approved as "life insurance reserves" in three audits by state insurance departments. (Tr. 278-279 and 348-349) Some of the managers covered under the plan retired and received benefits in 1958 and 1959. (App. 62a)

A manager's rights under the plan were forfeitable only on death, or ceasing to be a manager or agent of Jefferson before reaching age 65, or forming a connection with another life insurance company. (App. 59a-60a)

The plan did not qualify for pension plan treatment under Section 401, but disqualification by the Internal Revenue Service was not based upon the ground that benefits were forfeitable under certain contingencies. (App. 62a) Provisions for forfeiture of benefits in the event of termination are common provisions in pension plans, and are found in pension plans which qualify under Section 401.

The District Court held that the reserves under the plan were not "life insurance reserves", (App. 89a) and the Court of Appeals affirmed. (App. 32a-35a)

6. *Agents' Debit Balances.* Agents' debit balances are balances on the accounts of an insurance company that result from charges to the accounts of the company's agents against future commissions. (App. 76a-77a) Here the amounts arose principally from money advanced by Pilot to its agents to provide living expenses until their commission income was sufficient to support them. (App. 77a-78a) No interest was charged the agents on the balances. (App. 78a) Pilot maintained agents' debit balances because this was necessary to obtain and keep agents, since the company was competing for agents with other companies who financed their agents on a similar basis. (Tr. 328)

Section 805(b)(4) defines "assets" (to be taken into account in computing earnings rates for Phase I) so as to exclude assets used by a company "in carrying on an insurance trade or business." On the 1958 and 1959 tax returns, the Pilot and Jefferson agents' debit balances were excluded from "assets" for purposes of Section 805(b)(4) on the grounds that they were used in carrying on an insurance business.

The District Court held that these balances should have been included in "assets" as defined in Section 805(b)(4), (App. 92a) and the Court of Appeals affirmed. (App. 29a-32a)

7. *Consolidated return computations.* In 1958 and again in 1959, Pilot distributed $1,250,000 in dividends to Jefferson out of its earnings and profits for the year. (App. 46a) In the consolidated returns for 1958 and 1959, these intercompany dividends were eliminated completely in computing taxable investment income for Phase I of the life insurance company taxable income computations, and in computing gain from operations for Phase II. (App. 46a-48a) The inter-

company investment of Jefferson in the stock of Pilot was likewise eliminated from the consolidated asset base from which consolidated earnings rates were derived to determine the consolidated policy and other contract liability requirements under Phase I. (App. 47a)

This treatment was consistent with generally accepted accounting principles of consolidation which apply where an affiliated group composed of a parent corporation and its subsidiary (in this case, wholly-owned) file consolidated income tax returns. (App. 53a) Thus, the effect of the tax return treatment was the same as though Jefferson and Pilot had been separate divisions of a single life insurance company. (App. 56a-57a)

The Government contended that the intercompany dividends (and the intercompany investment for Phase I purposes) should be taken into account in the initial computations so that, in effect, the intercompany dividends would be applied in part to satisfy the so-called policyholders' share of investment income for both Phase I and Phase II purposes, with only the remainder of the intercompany dividends being eliminated. Thus, under the Government's contentions, for the Phase I and Phase II policyholders' share computations, the intercompany dividends and the intercompany investment were treated just as though Pilot had not been included in the consolidated tax returns. (App. 49a-52a)

The District Court held that, for purposes of the consolidated tax returns, the intercompany dividends paid by Pilot to Jefferson were not income (App. 88a) and that the intercompany investment of Jefferson in the stock of Pilot was not an asset (App. 89a); and further held that the consolidating methods and

procedures on the returns were proper. (App. 89a) The Court of Appeals reversed the District Court, holding that the Government's treatment of the intercompany dividends was proper. (App. 6a-10a) The Court of Appeals' opinion was silent on the treatment to be given the intercompany investment by Jefferson in the stock of Pilot.

8. *Tax rate applicable to the consolidated returns.* Starting with tax returns for 1958, the first year subject to the 1959 Act, the Internal Revenue Service redesigned the tax return for life insurance companies to call for payment of the additional 2% tax imposed by Section 1503(a) when the return was filed as a consolidated return by an affiliated group of life insurance companies. (App. 44a-45a) Section 1503(a) was not amended by the 1959 Act. It provided in part that ". . . the tax imposed under section 11(c) or section 831 shall be increased for any taxable year by 2 percent of the consolidated taxable income of the affiliated group of includible corporations." (App. 109a-110a) The tax on life insurance companies was imposed by Section 802(a) and provided that the surtax be computed ". . . at the rate provided by section 11(c)." (App. 98a)

Jefferson paid the 2% additional tax as called for by the redesigned return and sued for its refund in these actions in the District Court on the ground that the 2% tax had never been imposed on consolidated returns of life insurance companies. The District Court held that the 2% tax applied (App. 88a), and the Court of Appeals affirmed. (App. 20a-23a)

9. *Use of N.A.I.C. annual statement computations.* The National Association of Insurance Commissioners (N.A.I.C.) is a national organization established in 1871 that is composed of the insurance officials of the

states. The N.A.I.C. prescribes a uniform annual statement form that is required by law to be filed by life insurance companies with the insurance authorities of the states in which they are organized and do business. The N.A.I.C. also approves instructions for completion of the form. (App. 63a)

Jefferson and Pilot prepared and filed the annual statement forms with the State of North Carolina, where both companies were organized, and with the other states in which they did business. (App. 64a)

In its consolidated income tax returns, the taxpayer treated the loading element in deferred and uncollected premiums and unearned interest income as they were required to be treated on the N.A.I.C. annual statement (App. 73a and 68a); it allocated a portion of charitable contributions to general expenses as required for the N.A.I.C. annual statement (App. 69a-70a); and it set up life insurance reserves for its Branch Office Managers Supplemental Retirement Plan as required for the N.A.I.C. annual statement (App. 61a-63a). None of these computations was inconsistent with applicable provisions of the Internal Revenue Code.

The Court of Appeals did not accept the N.A.I.C. treatment for tax purposes with respect to any of these matters. (App. 12a-14a and 26a)

REASONS FOR GRANTING THE WRIT

This case offers an opportunity for this Court to answer the most troublesome questions of interpretation under the Life Insurance Company Income Tax Act of 1959. The rulings below that were adverse to the taxpayer involve eight issues of interpretation under that Act, and many are issues that are being widely litigated by insurance companies. There is also a conflict between the Circuits as to some issues,

and as to some issues, the rulings below misconceived the meaning of decisions of this Court.

1. (a) The Life Insurance Company Income Tax Act of 1959 (the 1959 Act) raises important questions of federal law that have not been, but should be, settled by this Court. Definitive interpretation by this Court of the most common issues that have arisen under the 1959 Act is badly needed to reduce the backlog of pending litigation and to resolve issues that are in dispute with the Internal Revenue Service throughout the country. The Solicitor General recognizes the importance of having the 1959 Act interpreted by this Court. In his brief in opposition to granting certiorari in *Franklin Life Ins. Co.* v. *United States,* 399 F. 2d 757 (7th Cir. 1968), *cert. den.,* ___ U.S. ___ (1969), he said:

> "* * * We would therefore not oppose certiorari even in the absence of a conflict if it appeared that present review would facilitate the final settlement of the income tax liabilities of this and other life insurance companies. But review would not dispose of those cases, since they involve other important questions of statutory construction—most of them industry-wide issues involving substantial amounts—as well as the deferred and uncollected premiums issue.[18] In addition, a grant of certiorari here well might freeze those cases in their present status and further postpone the date

"[18] For example, the appeal and cross-appeal of *Jefferson Standard Life Ins. Co.* v. *United States, supra,* argued and submitted to the Fourth Circuit on October 30, 1968, involves not only three of the four issues here but seven other issues of first impression under the 1959 Act. Similarly, *Occidental Life Insurance Co. of California* v. *United States* (C.D. Calif., Civ. No. 66-273-F) involves not only the deferred and uncollected premium issues but also four other issues of first impression. *Western National Life Ins. Co.* v. *Commissioner,* 50 T.C. No. 28, *supra,* still open on the Commissioner's motion for reconsideration, involves at least two other important issues besides deferred and uncollected premium issues."

on which audits of the life insurance companies may be closed."

Of the eight questions of interpretation under the 1959 Act as to which certiorari is requested in this case, six are of industry-wide concern. These are (1) whether the increase in loading on deferred and uncollected premiums is income; (2) whether the loading element in deferred and uncollected premiums should be treated as an asset; (3) the treatment of unearned interest income; (4) whether a portion of charitable contributions should be included in general expenses and deducted as such for Phase I purposes; (5) whether reserves set up for a non-qualified pension plan are life insurance reserves; and (6) whether agents' debit balances are "assets" as defined in Section 805(b)(4). All these questions are at issue in other pending tax cases of life insurance companies.[5] The following chart shows each of the

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[5] The following tax cases involving life insurance companies are pending:

Alaska Western Life Insurance Company, Tax Court Docket No. 3135-68.

Allstate Life Insurance Company, Tax Court Docket Nos. 1622-66, 5414-67.

American Fidelity Life Insurance Company, Tax Court Docket No. 4469-63.

The Andrew Jackson Life Insurance Company, Dist. Ct., N.D. Tex.

Bankers National Life Insurance Company, Tax Court Docket No. 655-68.

The Columbus Mutual Life Insurance Company, Tax Court Docket No. 1540-68.

Equitable Life Insurance Company of Iowa, Tax Court Docket No. 4701-68.

Eureka Life Insurance Company of America, Tax Court Docket No. 4513-68.

Farmers & Bankers Life Insurance Company, Dist. Ct., Kans., No. W-3977.

Globe Life Insurance Company, Dist. Ct., N.D. Ill., Civil No. 67-C-1991.

issues in this case which is of industry-wide interest, and each of the other pending cases in which the issue appears, for 22 of the 29 life insurance companies with pending tax cases. Also, as the chart shows, there are 20 other issues in pending cases that involve the question of use of N.A.I.C. annual statement computations in determining taxable income.

Group Life & Health Insurance Company, Dist. Ct., Tex.

ITT Hamilton Life Insurance Company, Court of Claims Docket No. 109-68.

Kentucky Central Life Insurance Company, Tax Court Docket No. 5290-67.

Lamar Life Insurance Company, Dist. Ct., S.D. Miss.

The Lyndon Life Insurance Company, Tax Court Docket No. 901-68.

The Midland Mutual Life Insurance Company, Tax Court Docket No. 5309-68.

National Life & Accident Insurance Company, Dist Ct., M.D. Tenn., Civ. No. 4995.

Occidental Life Insurance Company of California, Dist. Ct., C.D. Cal., Civ. No. 66-273-F.

The Ohio State Life Insurance Company, Tax Court Docket No. 5971-67.

Old Line Life Insurance Company of America, Dist. Ct., E.D. Wis., Civil No. 68-C-149.

Old Reliance Insurance Company, Court of Claims Docket No. 324-68.

Old Security Life Insurance Company, Tax Court Docket No. 4239-64.

Pioneer Life Insurance Company, Dist. Ct., N.D. Ill.

Security Benefit Life Insurance Company, Dist. Ct., Kans., No. T-4444.

Southwestern Life Insurance Company, Dist. Ct. Tex., Civil No. 3-3003-A.

Stuyvesant Life Insurance Company, Tax Court Docket No. 5654-68.

United Public Life Insurance Company, Tax Court Docket No. 6857-65.

Washington National Insurance Company, Tax Court Docket No. 3057-68.

Zurich Life Insurance Company, Court of Claims Docket No. 225-68.

ISSUES IN PENDING TAX LITIGATION BY THE LIFE INSURANCE INDUSTRY

Name of Taxpayer in Pending Case	Life Insurance Industry Issues					
	Increase in loading on deferred and uncollected premiums as income	Loading on deferred and uncollected premiums as "asset"	Treatment of unearned interest income	Deduction of charitable contributions as investment expense	Reserves of company's pension plan as life insurance reserves	Agents' deb balances as "assets" as defined in Section 805(b)
Columbus Mutual Life Ins. Co.	X	X	X			X
Equitable Life Ins. Co. of Iowa	X	X	X	X	X	X
Kentucky Central Life Ins. Co.	X	X	X			
The Midland Mutual Life Ins. Co.	X	X				
National Life & Accident Ins. Co.	X	X				X
Occidental Life Ins. Co. of Cal.	X	X				
Ohio State Life Ins. Co.	X	X	X	X		X
Security Benefit Life Ins. Co.	X	X				
Washington National Ins. Co.	X	X	X			
Lamar Life Ins. Co.						
Southwestern Life Ins. Co.	X	X	X			X
Stuyvesant Life Ins. Co.						
United Public Life Ins. Co.						
Pioneer Life Ins. Co.						
American Fidelity Life Ins. Co.	X	X				
Alaska Western Life Ins. Co.	X	X				
Eureka Life Ins. Co.	X					X
Old Line Life Ins. Co.	X					
Allstate Life Ins. Co.	X	X				
Bankers National Life Ins. Co.	X	X	X			
Old Reliance Ins. Co.	X					
Old Security Life Ins. Co.	X					
TOTAL	18	14	7	2	1	6

ISSUES IN PENDING TAX LITIGATION BY THE LIFE INSURANCE INDUSTRY

Pending Case	Life Insurance Industry Issues						
	Increase in loading on deferred and uncollected premiums as income	Loading on deferred and uncollected premiums as "asset"	Treatment of unearned interest income	Deduction of charitable contributions as investment expense	Reserves of company's pension plan as life insurance reserves	Agents' debit balances as "assets" as defined in Section 805(b)(4)	Other issues involving application of N.A.I.C. annual statement computations (number of issues in parenthesis)
ife Ins. Co.	X	X	X			X	X (1)
Co. of Iowa	X	X	X	X	X	X	X (7)
ife Ins. Co.	X	X	X				
l Life Ins. Co.	X	X					
ident Ins. Co.	X	X				X	
Co. of Cal.	X	X					X (1)
Co.	X	X	X	X		X	X (7)
e Ins. Co.	X	X					
al Ins. Co.	X	X	X				X (3)
ns. Co.	X	X	X			X	
. Co.							
ns. Co.							
).							
ife Ins. Co.	X	X					
e Ins. Co.	X	X					
.	X					X	X (1)
o.	X						
).	X	X					
ife Ins. Co.	X	X	X				
).	X						
s. Co.	X						
	18	14	7	2	1	6	6 (20)

This case clearly meets the Solicitor General's own standards for a case that would facilitate final settlement of a large number of the substantial industry-wide issues involving interpretation of the 1959 Act.

(b) In holding that the increase in loading is income, and that loading is an asset within the meaning of Section 805(b)(4), the Court of Appeals has misconceived the nature of loading and has attributed to it a relationship with gross premiums that demonstrably does not exist. This misconception is manifest in two fallacious propositions upon which the Court rested its opinion with respect to these questions:

> That deferred and uncollected premiums are legally accruable as income, and that hence some "deduction" must be found in the statute before the loading can be eliminated; and
>
> That the portion of the reserve equal to the net valuation premium has some fixed or mathematical relationship to gross premiums in the same sense, for example, that a bad debt deduction has a relationship to gross receipts.

(i) The Court of Appeals searched for a statutory "deduction" for the increase in loading and concluded that there was none.[6] It apparently sought a statutory deduction on the ground that the gross deferred and uncollected premiums were includible by statute in income, yet there is no such statutory provision for inclu-

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[6] The Court could, however, have found a deduction for deferred and uncollected premiums as "unearned premiums" under Section 809(d)(2), which provides a deduction for the net increase in certain reserves, including reserves for "unearned premiums" not included in life insurance reserves. See Section 810(c)(2), referring to Section 801(c)(2).

sion. This is quite understandable, because gross deferred and uncollected premiums would not be included in gross premiums under accrual principles of accounting, since the company has not received them and has no right to receive them. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963). Indeed, at one point the Court of Appeals seems to recognize this when it says: "Presumably, taxpayer is not required to include in income amounts which it has not received or which it has no right to receive . . ." (App. 26a) It is highly significant that taxpayer did not make the concession made by the taxpayer in the *Franklin Life* case to the effect that the intent and purpose of the Act require that deferred and uncollected premiums be included in income on a gross basis.[7] (See App. 25a.) This point distinguishes the *Franklin* case from the case at bar.

If the taxpayer is not required by statute to include the loading on deferred and uncollected premiums in income but merely follows the N.A.I.C. procedure for convenience and to comply with industry accounting, it is obviously not required to find a statutory deduction to eliminate the loading element. The elimination of the loading is merely an offsetting accounting entry or adjustment made to prevent taxing a non-income item, and to balance the accounts to reflect the fact that the reserves required by state law are computed on a net valuation premium basis. In contending other-

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[7] This concession was given great weight by the Court in the *Franklin* case (399 F.2d at 760), which said:

> "Taxpayer concedes that the intent and purpose of the Act require that the deferred and uncollected premiums be included in income on a gross basis (which includes loading). *In our view that concession leaves no basis for further controversy.*" (Emphasis supplied.)

wise the Government is seeking to use that part of the N.A.I.C. treatment which is useful to it, and then discarding the other part of the treatment by which the corrective adjustment is made. In accepting the Government's contentions the Court of Appeals admits that the issue as to the includability in income of the increase in loading "is not totally free from doubt." (App. 26a) The effect of the Court's decision is to subject to taxation amounts which the taxpayer has not received and which he has no right to receive, contrary to all principles of accrual accounting.

While the Commissioner, subsequent to the years at issue, adopted a regulation that purports to include gross deferred and uncollected premiums in gross premium income (Reg. § 1.809-4(a)(1)(i)), no such intent can be gleaned from the wording of Section 809(c) or its legislative history, and the regulation is obviously an attempt by the Commissioner, in effect, to legislate interstitially.

(ii) The second fallacy in the Court of Appeals' opinion is that inclusion of loading is based upon some assumed relationship between the "full annual net valuation premium" and the "gross annual premium." (App. 27a) This conclusion is unsound because the loading element is simply a residual amount, and this may be demonstrated as follows:

Consistent with state law regarding the maintenance of reserves, the amount to be added to reserves is the net valuation portion of the deferred and uncollected premiums. *It is only this amount* that must be included in income to create an asset equivalent to the reserve requirement. Ordinarily the net valuation premium is less than the gross premium and the difference is the loading.

The loading has no pertinence or function whatever in arriving at the amount to be added to reserves. It enters the picture only because it is a portion of gross deferred and uncollected premiums, and because, under the N.A.I.C. requirements, the gross premiums are initially taken into account as income solely for actuarial convenience—i.e., to prevent the necessity of multiple computations which would be involved if reserves had to be computed separately for each different premium payment method. Thus, only one portion of the gross premiums is pertinent—the net valuation premiums. To extract this from gross premiums the N.A.I.C. procedure simply sets aside the residual element comprising the loading portion, which does not in any way enter into the computation of the reserves.

In *Western National Life Ins. Co. v. Commissioner*, 51 T.C. No. 81 (1969), the Tax Court held loading on deferred and uncollected premiums was not includible in assets. There are 18 other pending cases involving the issue of increase in loading on deferred and uncollected premiums as income, and there are 14 other pending cases involving the issue of treatment of loading on deferred and uncollected premiums as an asset.

(c) The reasons for granting the writ with respect to the treatment of unearned interest income on policyholders' loans are treated in part 3 of this section of the petition. The question is at issue in seven other pending cases.

(d) The ruling below is erroneous in holding that charitable contributions were not general expenses that were allocable in part to investment expenses and thus deductible in computing taxable investment income for Phase I. While charitable contributions are not *de-*

ductible as trade or business expenses under Section 162 and are thus deductible only within the limitations prescribed in Section 170, this does not mean that they may not be general expenses. Section 162(b) does not state that charitable contributions are not expenses; it states that even when they are expenses they may not be deducted under Section 162. See the report of the Committee on Ways and Means on the Revenue Act of 1938, which first denied corporate charitable contributions as deductions under the trade or business expense deduction provision. (75th Cong., 3rd Sess., H. Rept. 1860, pp. 17-18.)

The N.A.I.C. annual statement requires that charitable contributions be reflected in general expenses and that they be broken down between insurance expenses and investment expenses on a reasonable basis. (App. 69a) Since the annual statement treatment is not inconsistent with the provisions of the Code, Section 818(a) requires this treatment for tax purposes.

There are two other pending cases involving this issue.

(e) The Court of Appeals committed two basic errors in holding that the reserves for the Branch Office Managers Supplemental Retirement Plan did not qualify as "life insurance reserves" under Section 801(b) and Reg. § 1.801-4:

First, it gave controlling weight to the fact that under certain circumstances some of the benefits were forfeitable, sweeping aside the consideration that the same thing is true under pension plans that qualify under Section 401. Forfeitability is a very common provision, and if it were a controlling factor in qualifying reserves as "life insurance reserves", few pension plans indeed would ever be capable of qualifica-

tion. It is not "irrelevant" (App. 35a) that plans under Section 401 can contain forfeitability provisions, since plans under that Section are governed by even stricter requirements than apply to unqualified plans. During the years in question a number of branch office managers were retired and received benefits under the plan. (App. 62a) Just as in other plans, they had a right to continue to receive the benefits until and unless a forfeiture occurred under the terms of the plan. There is no ground whatsoever for denying the plan reserves the status of "life insurance reserves" when that status is accorded to other pension plans having forfeitability provisions.

A second error in the Court's opinion is a misinterpretation of the relationship between "life insurance reserves" and "pension plan reserves." This error is apparent in the Court's statement that, "It is hardly likely that an intelligible legislative purpose would be served in providing that reserves for an insurance company's own pension plan may be recognized in computing the policyholders' share only if the plan qualifies under § 401, if the same reserves are to be recognizable in any event as life insurance reserves." (App. 34a)

The legislative purpose becomes apparent when it is recognized that there is a distinct tax advantage to an insurance company in having a pension plan qualified under Section 401 so that its reserves will be treated as "pension plan reserves" under Section 805(d)—an advantage not available if the plan is not qualified, in which case its reserves are taken into account as life insurance reserves under Section 805(c)(1). When a reserve falls under Section 805(d) the insurance company can exclude, for Phase I purposes, the total amount of interest on it at the rate actually earned,

as contrasted to Section 805(c) reserves as to which interest may be excluded only at the adjusted rate.[8]

(f) The Court below misconceived the meaning of this Court's decision in *United States* v. *Correll,* 389 U.S. 299 (1967), when the Court below stated that the *Correll* decision was controlling on the issue of the validity of the Treasury Regulations on the treatment of agents' debit balances. The question here is whether agents' debit balances are "assets" as defined in Section 805(b)(4) or, instead, are assets used in the insurance trade or business.

Reg. § 1.805-5(a)(4) limits assets used in carrying on an insurance trade or business, as that term is used in Section 805(b)(4), to tangible assets, and specifically excludes agents' debit balances from the category of assets used in carrying on an insurance trade or business. The Treasury Regulations cannot validly limit the category of property used in carrying on an insurance trade or business to *tangible* assets when the statute does not do so, and this Court's decision in the *Correll* case does not direct the lower courts to sanction such an arbitrary and illegal exercise of regulatory authority.

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[8] The Ways and Means Committee report on the 1959 Act said, "A larger deduction is provided under the bill with respect to investment income earned in connection with reserves accumulated for qualified employer pension and profit-sharing plans." H. Rep. No. 34, 86th Cong., 1st Sess., 1959-2 C.B. 739. The Senate Finance Committee report on the 1959 Act said, "The favorable treatment for qualified pension and profit-sharing business is believed desirable in view of the fact that investment earnings of a qualified pension or profit-sharing trust are completely exempt from tax while they are accumulated in the trust." S. Rep. No. 291, 86th Cong., 1st Sess., 1959-2 C.B. 775.

Agents' debit balances are excellent examples of *intangible* assets used in the business of selling insurance, since they are used to obtain and to keep the agents whose job it is to sell insurance.

There has been one decision contrary to the taxpayer's position on this issue. This was *Western National Life Insurance Co.* v. *Commissioner,* 50 T.C. 285 (1968).[9] It is not clear from its opinion that the Tax Court appreciated that assets used in an insurance trade or business were not "assets" for purposes of Section 805(b)(4) even though they were assets in every other respect. Furthermore, the taxpayer in the *Western National Life* case apparently did not establish in the record that no interest was charged on the balances. (See App. 78a) The Tax Court did not foreclose the possibility of a contrary decision on different facts, saying:

> ". . . we cannot, *on this record,* conclude that respondent's regulation, sec. 1.805-5(a)(4)(i), which specifically includes these items in assets, is an arbitrary and unreasonable interpretation of the statute." (Emphasis supplied.)

This issue is involved in six other pending cases.

2. (a) There is a conflict between the courts of appeals over use of computations for the annual statement approved by the National Association of Insurance Commissioners in the computation of tax liability of insurance companies.

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[9] Contrary to the opinion of the Court below, *Franklin Life Insurance Co.* v. *United States,* 67-2 U.S.T.C. ¶ 9515 (S.D. Ill. 1967), reversed on other issues, 399 F.2d 757 (7th Cir. 1968), cert. den. — U.S. — (1969), did not involve this issue.

The conflict first arose in cases involving fire and casualty insurance companies. With respect to these companies, Section 832(b)(1) provides that gross income means, among other items, "(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, . . .". The same rule was contained in the 1939 Code and in prior Revenue Acts. In *Commissioner* v. *New Hampshire Fire Insurance Co.*, 146 F. 2d 697 (1st Cir. 1945), the First Circuit held that this language meant precisely what it said, and that underwriting income should be computed on the basis of the annual statement even though the effect was to fail to recognize transactions with so-called "unadmitted companies". In reaching this decision the court rejected a contention by the Commissioner that Congress must have intended the statute to reach all underwriting income and that to achieve this purpose it intended use of the annual statement form merely as a general guide and only insofar as it was not in conflict with detailed and explicit provisions of the statute with respect to computation of underwriting income. The court quoted with approval the Tax Court's opinion that the annual statement form "should be followed precisely according to its terms and as employed, accepted, and complied with throughout the United States."

The Fourth Circuit followed the First Circuit in holding that underwriting income of fire and casualty insurance companies should be computed on the basis of the annual statement. *United States* v. *Fidelity and*

Deposit Co. of Maryland, 177 F. 2d 805 (4th Cir. 1949), rehearing den. 178 F. 2d 753 (4th Cir. 1950).

Subsequently, the Ninth Circuit, while noting that the decisions by the First and Fourth Circuits were contrary to its own earlier decision in *Pacific Employers Insurance Co.* v. *Commissioner,* 89 F. 2d 186 (9th Cir. 1937), reaffirmed its own earlier decision in *Pacific Insurance Co.* v. *United States,* 188 F. 2d 571 (9th Cir. 1951). The Second Circuit reached the same conclusion as the Ninth Circuit in *Commissioner* v. *General Reinsurance Corp.,* 190 F. 2d 148 (2nd Cir. 1951), reversing a decision by the Tax Court, which had followed its own previous decisions that had been affirmed by the First Circuit and the Fourth Circuit in the cases cited above. Notwithstanding the square conflict between the First and Fourth Circuits, on the one hand, and the Ninth and Second Circuits, on the other hand, none of the parties petitioned this Court to grant certiorari.

Substantially the same issue is raised by the language of Section 818(a), as added by the 1959 Act:

> "(a) *Method of Accounting.*—All computations entering into the determination of the taxes imposed by this part shall be made—
>
> (1) under an accrual method of accounting, or
>
> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> Except as provided in the preceding sentence, all such computations shall be made in a manner con-

sistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners."

The annual statement computations are pertinent to five of the issues in this case: (1) whether an increase in loading on deferred and uncollected premiums is income; (2) whether the loading element in such premiums should be treated as an asset; (3) the treatment of unearned interest income; (4) whether a portion of charitable contributions should be included in general expenses and deducted as such for Phase I purposes; and (5) whether reserves set up for a Branch Office Managers Supplemental Retirement Plan were "life insurance reserves." The Court below refused to follow the annual statement computations on these five issues, thus aligning itself with the Ninth and Second Circuits on the role of annual statement computations. Strangely, the opinion of the Court of Appeals below does not refer to the earlier contrary position of the Fourth Circuit in the *Fidelity and Deposit Co. of Maryland* case.

This is the first time the conflict between the courts of appeals over the meaning of the references in the Internal Revenue Code to annual statement computations has been brought before this Court. We submit that it is an important question of interpretation of federal tax law that should be resolved by this Court.

(b) A decision by this Court on the extent to which N.A.I.C. annual statement computations should be used will resolve the largest area of conflict between taxpayers and the Government over interpretation of the 1959 Act. Counsel for six of the 29 pending tax suits by life insurance companies involving interpretation of the 1959 Act reported that they had issues in-

volving the question of whether or not N.A.I.C. annual statement computations should be used in computing taxable income in addition to the issues in this case. They reported 20 such additional issues.

3. (a) In deciding the issue involving timing of reporting of unearned interest income, the Court below misconceived the meaning of this Court's decisions in *Schlude* v. *Commissioner,* 372 U.S. 128 (1963), *American Automobile Association* v. *United States,* 367 U.S. 687 (1961), and *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180 (1957). This Court's decisions in those cases did not establish an absolute rule that all accrual basis taxpayers must return all prepaid receipts in income in the year received. In each case, this Court was content to approve in the particular case the Commissioner's exercise of his authority under Section 446(b) and Reg. § 1.446-1 to reject the taxpayer's accounting method and to include the prepaid amounts in income. In each case, this Court carefully pointed out flaws in the method used by the taxpayer to allocate advance receipts on a when-earned basis, showing in each case that the income allocation by the taxpayer did not reflect with complete accuracy the performance of the services by which the income was earned.

The Court below ruled that the taxpayer was required to report in income interest paid in advance on loans to policyholders that would not be earned until a later year and that would have to be rebated if the principal amount of the loan was prepaid. The Court below said *Franklin Life Insurance Company* v. *United States,* 399 F. 2d 757 (7th Cir. 1968), cert. den. U.S. (1969), was dispositive of the issue and also referred to the decision in the *Schlude* case. (App. 27a and 29a) The decision of the Seventh Circuit in

the *Franklin Life* case, in turn, relied upon this Court's decisions in the *Schlude* and *American Automobile Association* cases. In both the instant case and the *Franklin Life* case the taxpayer's method of accounting was rejected without any showing by the Commissioner that the taxpayer had failed accurately to reflect income. Thus, the decisions of this Court, in cases where the Court was careful to explain how the Commissioner's action in overturning the taxpayer's accounting method was correct under the circumstances, have been used as authority for blind, automatic rejection of an established method of accounting for prepaid interest income without any inquiry as to the accuracy with which the taxpayer's method of accounting reflected the services rendered in earning the income.

The basic flaw in the methods of accounting rejected in the *Schlude, American Automobile Association,* and *Automobile Club of Michigan* cases was that the prepaid amounts that were deferred by those taxpayers could not be specifically related in each instance to services to be performed subsequent to the year of receipt. The method of accounting for prepaid interest income by the taxpayer here does not fail this test. The service performed here was the use of money, and the charge for the service performed is related precisely to the passage of time. Consequently, no estimates and no speculation are involved. The taxpayer's method of accounting for unearned interest income precisely measured the services performed, and, indeed, the Government has not contended otherwise. Thus, this case offers to this Court a perfect opportunity to define the limits of the *Schlude* case or, if the Court now wishes to make the reporting of prepaid

income an absolute rule for all circumstances, this case offers the Court a perfect opportunity to expand the doctrine of the *Schlude* case to do so.

(b) There is a conflict between the courts of appeals as to whether or not this Court's decisions prescribe an invariable rule that income must be reported when received in all cases. The conflict is between, on the one hand, the decision by the Fourth Circuit in this case, the decision by the Seventh Circuit in the *Franklin Life* case, and the decision by the Sixth Circuit in *Hagan Advertising Displays, Inc.* v. *Commissioner,* 407 F. 2d 1105 (6th Cir. 1969), and, on the other hand, the decision by the Seventh Circuit in *Artnell Company* v. *Commissioner,* 400 F. 2d 981 (7th Cir. 1968).

The *Artnell* case involved the issue of whether a predecessor corporation, Chicago White Sox, Inc., was taxable on revenues it had received in advance from the sale of tickets to baseball games that had not been played, from the sale of broadcasting and television rights to such baseball games, and from the sale of season parking books when its taxable year (which normally would have run to October 31) ended with its liquidation on May 31, during the baseball season. The Seventh Circuit held that the Tax Court had erred in deciding that these revenues were income when received, regardless of the merits of the method of accounting employed to allocate the revenues between the period before and the period after the close of the taxable year on May 31. The cause was remanded to the Tax Court to determine whether the method of accounting used by Chicago White Sox, Inc. did clearly reflect its income in its final, seven month taxable year.

Both the *Artnell* case and the *Franklin Life* case were decided by the Seventh Circuit in the same year. They were decided by different panels of judges, and neither opinion refers to the other case. We submit that they are flatly in conflict with one another.

The opinion of the Sixth Circuit in the *Hagan Advertising Displays* case recognizes the conflict with the Seventh Circuit's decision in the *Artnell* case, stating in a footnote, "To the extent *Artnell Co.* v. *Commissioner,* 400 F. 2d 981 (7th Cir. 1968), is inconsistent with our decision, we decline to follow it."

This Court denied a petition for certiorari by the taxpayer in the *Franklin Life* case. The Government did not request certiorari in the *Artnell* case. While distinctions can be drawn between the *Artnell* case and the instant case, these are distinctions without a difference in principle. If anything, the taxpayer here can make a stronger case than the taxpayer in the *Artnell* case for acceptance of the taxpayer's method of accounting for prepaid income.

4. (a) The ruling below on the issue of how to treat intercompany dividends in computing consolidated taxable income of an affiliated group of life insurance companies misconceives the meaning of this Court's decision in *United States* v. *Atlas Insurance Co.,* 381 U.S. 233 (1965). It is based upon a mistaken analogy to a different question of interpretation considered in the *Atlas* case.

The issue in the *Atlas* case was how to interpret Section 804(a)(6) and Section 809(b)(4). Those provisions provided that if application of the definition of taxable investment income or gain from operations resulted in imposition of taxes on tax-exempt interest.

partially tax-exempt interest, or any amount of dividends received which was allowed as a deduction under Sections 243, 244, or 245, adjustments should be made to prevent such imposition. This Court held that, where no special circumstances were shown, these provisions did not mean that no part of the policyholders' share of investment yield could be satisfied out of tax-exempt interest income.

The *Atlas* case did not involve intercompany dividends—that is, dividends distributed from a subsidiary company to its parent company in a year for which the subsidiary and the parent filed a consolidated return. Consequently, the *Atlas* case did not involve the accounting treatment of intercompany transfers among affiliates reporting a single taxable income figure on a consolidated return. Furthermore, such intercompany dividends are not covered by Sections 804(a)(6) and 809(b)(4).

Since it did not involve consolidated returns, the decision in the *Atlas* case did not, of course, involve the question of whether or not the explicit provisions of the consolidated return regulations for elimination of intercompany dividends should be ignored. Instead, the *Atlas* case involved whether or not items of *income* should be allocated between a company's share and a policyholders' share. A dividend distribution within a group of affiliates making a consolidated return is not an item of income for the consolidated reporting unit under any accounting theory. (App. 53a) Nor is it an item of income for tax purposes, since the consolidated return regulations provide, explicitly and without exception, for its elimination. Reg. § 1.1502-31A (b)(1)(i).

The ruling below, by requiring a dividend distributed within the affiliated group to bear a portion of the policyholders' share, satisfies a portion of the policyholders' share out of investment income that is being taxed to the group on the same consolidated return. (This was Finding of Fact No. 55 of the District Court, which was not disturbed by the Court of Appeals.) (App. 56a) This occurs because the dividend is paid from current earnings and profits of the subsidiary, which is the company's share of its gain from operations for the year, as is illustrated by the following example of the operation of the Phase II tax computation:

> For 1958 the effect of the adjustments made by the Revenue Service was to meet $635,069.00 of the required interest requirements for Jefferson (the parent company) out of the $1,250,000.00 of dividends received from Pilot (the subsidiary). Since the entire $1,250,000.00 was distributed out of the company's share of Pilot's gain from operations, treating $635,069.00 as satisfying required interest of Jefferson meant that the required interest of the affiliated group (consisting of Jefferson and Pilot) was being satisfied to that extent out of investment income *that was already being taxed to the group for the same year on the same tax return.*

Thus, the ruling below would tax investment income set aside under the 1959 Act computations to satisfy obligations of policyholders—contrary to the 1959 Act and to this Court's interpretation of it in the *Atlas* case:

> "* * *. In arriving at taxable investment income and gain from operations, the 1959 Act, consistent

with prior law in this regard, recognizes that life insurance companies are required by law to maintain policyholders reserves to meet future claims, that they normally add to these reserves a large portion of their investment income *and that these annual reserve increments should not be subjected to tax.* * * *" (381 U.S. 233, 235-236) (Emphasis added)

(b) The ruling below is in conflict with decisions of the Second Circuit that the interpretation of a statute contained in the consolidated return regulations must be accepted unless inconsistent with the statute. The consolidated return regulations are not ordinary, interpretative regulations. Instead, they are "legislative" regulations. Section 1502. S. Rep. No. 960, 70th Cong., 1st Sess., p. 15 (1928), 1939-1 C.B. (Part II) 419. They are applicable only if all the corporations that are members of the affiliated group consent to them, in the form in which they are prescribed prior to the last day for filing the return. Reg. § 1.1502-1A. The consent is accomplished by making the consolidated return. Section 1501.

Broad regulatory authority over consolidated return computations, accomplished through the mechanism of taxpayer consent to the regulations, was devised in 1928 as a solution for the tremendous volume of litigation that had plagued administration of consolidated returns from their beginning in 1917. The device of broad regulatory authority through consent regulations has largely accomplished its purpose of minimizing litigation and providing certainty. Broad regulatory authority under consent regulations is a two-way bargain, however, and taxpayers are entitled to rely on the plain meaning of the consolidated return regulations to which they have consented. That is at the heart of the taxpayer's contention here.

The role of the consolidated return regulations and the extent to which taxpayers may rely on them are important questions of federal law, worthy of this Court's attention. Use of consolidated returns has increased sharply. For 1964 consolidated returns accounted for 32% of the income tax reported by all corporations. They were filed for nearly 7,500 parent corporations with 36,400 subsidiaries.

The consolidated return regulations applicable to the years involved in this case provided explicitly and without exception for the elimination of intercompany dividends. Reg. § 1.1502-31A(b)(1)(i). (The current consolidated return regulations still provide for elimination of all intercompany dividends, though they were completely overhauled and revised subsequent to the 1959 Act and subsequent to this Court's decision in the *Atlas* case. Reg. § 1.1502-14(a)(1).) Furthermore, the regulations provide clearly that the intercompany dividend elimination is to take place at the outset, before any separate company computations. Rev. Rul. 60-289, 1960-2 C.B. 268, and G.C.M. 15599, XIV-2 C.B. 240.

The Court of Appeals for the Second Circuit has held on two occasions that the interpretation of a statute by the consolidated return regulations must be accepted unless it is inconsistent with the statute. *American Trans-Ocean Navigation Corp.* v. *Commissioner,* 229 F. 2d 97 (2nd Cir. 1956), and *American Water Works Co., Inc.* v. *Commissioner,* 243 F. 2d 550 (2nd Cir. 1957). The ruling below is in conflict with these decisions.[10]

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[10] The opinion below does not even recognize the special role of the consolidated return regulations.

5. (a) In ruling that the additional 2% tax imposed by Section 1503(a) applied to consolidated returns filed by an affiliated group of life insurance companies, the Court below has enlarged a tax-imposing statute, in conflict with the applicable decisions of this Court. A tax-imposing statute must be interpreted precisely according to its language. The provisions of an income tax statute are not to be extended by implications beyond the clear import of the language used. *Gould* v. *Gould,* 245 U.S. 151 (1917). See also *Smietanka* v. *First Trust & Sav. Bank,* 257 U.S. 602 (1922); *United States* v. *Merriam,* 263 U.S. 179 (1923). It is beyond the power of the courts to enlarge upon or extend the scope of a tax-imposing statute to subjects not covered by the law. *Iselin* v. *United States,* 270 U.S. 245 (1926). *McFeely* v. *Commissioner,* 296 U.S. 102 (1935).

In *United States* v. *Leslie Salt Co.,* 350 U.S. 383 (1956), in construing the provisions of a statute imposing a documentary stamp tax, the Court said, "We must deal with the statute as we find it, . . ." *Reinecke* v. *Gardner,* 277 U.S. 239 (1928), illustrates the rule.

The Court below cited statements showing a general Congressional intent in enacting the 1959 Act to tax life insurance companies as other corporations were taxed.[11] (App. 22a) On the basis of these statements, it decided that Congress intended to impose the 2% tax on consolidated returns by life insurance companies when it enacted the 1959 Act, *though no tax-imposing language for the 2% tax was written into the*

[11] In fact, some other corporations were not subject to the 2% tax.

law in 1959.[12] Such an approach to statutory interpretation is contrary to *McFeely* v. *Commissioner,* 296 U.S. 102 (1935), where this Court refused to alter the "plain meaning" previously attributed to a provision (relating to holding period) that had been in effect under earlier Revenue Acts in order to make it consistent with a new provision (relating to basis) when the language of the holding period provision was reenacted without change. This Court said:

> "Under these circumstances we ought not to depart from the plain meaning of the section in an effort to bring about a uniformity which it is claimed Congress intended but failed to express."

(b) The theory on which the Court below decided the 2% consolidated return tax issue is contrary to a longstanding administrative interpretation of Section 1503(a), and if it is correct, then thousands of other affiliated groups of corporations have overpaid the 2% tax.[13] The Court below said, "We conclude that the only reasonable overall interpretation of the statutory language is that when the *surtax* imposed by § 11

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[12] From the opinion of the Court below, it apparently felt it necessary to enlarge the tax-imposing statute to apply the 2% tax to life insurance companies filing consolidated returns in order to avoid a conclusion that the tax would not apply to ordinary business corporations filing consolidated returns. (App. 21a) The Court below was not really faced with this dilemma. The difference between the words "computed at the rate provided in section 11(c)" in Section 802(a)(1) and the words "a surtax computed under subsection (c)" in Section 11(a) is sufficient to save the tax for ordinary business corporations.

[13] See *United States* v. *Leslie Salt Co., supra,* where this Court said, ". . . against the Treasury's prior longstanding and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand." (Page 396)

on ordinary business corporations *was increased by § 1503,* that increase was equally applicable to life insurance companies by virtue of the provisions of § 802(a)(1)." (Emphasis added) (App. 22a) This interpretation flatly contradicts the position that was taken by the Internal Revenue Service in calculating the base to which the 2% tax should apply in the case of ordinary business corporations.

The Revenue Service has ruled (correctly, in our opinion) that the 2% tax was a separate tax—*not* an increase in the surtax imposed by Section 11. Consequently, the corporate income tax returns were designed by the Revenue Service to apply the 2% tax to the entire consolidated taxable income of ordinary business corporations filing consolidated returns, without a $25,000 surtax exemption. If the 2% tax was an increase in the surtax it would not apply to the first $25,000 of consolidated taxable income, since the first $25,000 was exempt from surtax. In explaining its position in Rev. Rul. 58-246, 1958-1 C.B. 339, the Revenue Service said, "Such tax [the 2% tax] is imposed in addition to the surtax otherwise imposed on such corporations under section 11(c) of the Code with respect to taxable income which exceeds $25,000."

If the Court below is correct that the 2% tax was an increase in the surtax, then a sum vastly in excess of the amount at issue here has been collected illegally from other corporations over the years. No taxpayer has contested the Revenue Service's position in court, and most of the returns on which the 2% tax was imposed on the first $25,000 are probably now closed by the statute of limitations, though some returns being processed administratively are still open for refund on this point. More importantly, if the interpretation of

the 2% tax in this case by the Court below is allowed to stand, taxpayers generally who have paid the 2% tax on income not subject to surtax may well feel that the Revenue Service has dealt with them in bad faith.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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